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No. 92-___

In The

## Supreme Court of the United States

October Term, 1992

ANDREW L. SMITH,

*Petitioner,*

v.

R. JACK AYRES, JR.,

*Respondent.*

**On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Fifth Circuit**

## PETITION FOR WRIT OF CERTIORARI

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## QUESTIONS PRESENTED

1. Has the federal common law concerning the general assignability of a federal securities fraud claim by express assignment of the claim been changed to a case-by-case fact-sensitive inquiry based on the policy concerns discussed in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975)?

2. Can the court of appeals affirm the dismissal of Plaintiff's claims based on two fact-sensitive inquiries not argued by the Defendant and not relied upon by the district court in dismissing Plaintiff's claims, and for which Plaintiff was not accorded a full and fair opportunity to provide controverting evidence?

3. Where a district court erroneously dismisses Plaintiff's federal claim, and in connection therewith dismisses Plaintiff's pendent state law claims for lack of federal jurisdiction pursuant to *United Mine Workers v. Gibbs*, 383 U.S. 715, 727 (1966), is it necessary for the court of appeals to formally remand the pendent state law claims along with the erroneously dismissed federal question claim in order for the district court upon remand to reacquire pendent jurisdiction over the state law claims?

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## PETITION FOR WRIT OF CERTIORARI

## OPINIONS BELOW

This petition seeks review of a decision of the United States Court of Appeals for the Fifth Circuit, which is reported at 977 F.2d 946 and reprinted as Appendix A.[1] The Memorandum Order of the United States District Court for the Northern District of Texas, Dallas Division (Fish, J.) is unreported and reprinted as Appendix B. The judgment dismissing Plaintiff's claims is reprinted as Appendix C.

[1] References to the appendices will be styled "A ___".

## JURISDICTION

The decision and judgment of the court of appeals were entered on November 23, 1992. A timely petition for rehearing was denied on December 21, 1992. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

## STATEMENT OF THE CASE[2]

This case involves the fraudulent conduct by Defendant R. Jack Ayres, Jr. ("Ayres") and his co-conspirators, Clayton J. Smith ("Clayton") and Mark L. Smith ("Mark"), in connection with the issuance of 26% of the stock of Smith Protective Services, Inc. ("SPS" or the "Company") to Clayton. Andrew, both individually and derivatively on behalf of SPS, brought suit against (1) Ayres, who was the corporate attorney for SPS and the mastermind of the stock fraud scheme; and (2) Clayton and Mark, who conspired with Ayres to defraud SPS into reissuing stock to Clayton for the purpose of shifting control of the Company away from Andrew and Mrs. Smith over to Clayton and Mark.

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[2] The district court granted the Defendant's Supplemental Motion to Dismiss. (A2). The facts as stated herein are supported by Plaintiff's Second Amended Complaint and the summary judgment evidence submitted by Plaintiff in opposition to Defendant's Motion for Summary Judgment, with all justifiable inferences to be drawn in Plaintiff's favor. *H.J., Inc. v. Northwestern Bell Telephone Co.*, 492 U.S. 229, 249-50 (1989); *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 255 (1986). Although the Fifth Circuit's opinion repeatedly refers to this suit as a "class action" (A1, 2 & 10), this is not a class action and no class action allegations were made by Plaintiff.

In 1977 the shareholders of SPS were Andrew, with 26% of the stock; Andrew's mother, Coralie C. Smith, with 22%; and Andrew's brothers, Clayton and Mark, each with 26% of the stock. In June of 1977 Mrs. Smith, Andrew and Mark discovered that Clayton had embezzled over $50,000 from SPS. Accordingly, SPS had its regular outside counsel, Ayres, file suit on behalf of the Company against Clayton to recover the embezzled funds. Thereafter, Ayres, on behalf of SPS, and Clayton's independent counsel, James J. Robertson, negotiated a settlement of the Company's embezzlement claims against Clayton. As part of the settlement Clayton agreed to sell his SPS stock back to the Company.

After completing the stock redemption, Andrew and Mark each held 35% of the outstanding shares, while Mrs. Smith held 30%. With their combined majority stake, Andrew and his mother had effective control of SPS.

In early 1983 numerous conflicts developed between Mark and Andrew over Mark's management of the Dallas office of SPS, and Mark was searching for ways to get Andrew out of control of the Company. So Mark turned to the Company attorney, Ayres, for guidance on what to do about Andrew's control over SPS. As a result of his conferences with Ayres, Mark learned that one way to change management of the Company was to change ownership of the Company, and that if the SPS board voted to "rescind" the 1977 stock redemption transaction whereby Clayton sold his stock back to SPS, majority control of SPS would shift from Andrew and Mrs. Smith to Mark and Clayton.

During that same period a fee dispute developed between Andrew and Ayres over fees that Ayres claimed were due by SPS. Just before the crucial July 22 board of directors meeting, Ayres and Andrew did not get along, and Ayres, like Mark, wanted Andrew out of control of SPS. Ayres knew that if Clayton could get his stock back voting control of SPS would shift from Andrew and Mrs. Smith to Clayton and Mark.

In July of 1983 a plan was developed by Clayton, Mark and Ayres to reissue SPS stock to Clayton and thereby wrest control of SPS away from Andrew and Mrs. Smith. In April of 1983 the SPS board of directors had been expanded beyond the Smith family (Mrs. Smith, Andrew and Mark) to include six other individuals, for a total of 9 directors. Mr. Shelby Denney was elected to the board, and he subsequently became chairman of the board and president of SPS.

On the night of July 14, 1983 Mr. Denney received a conference call at his house from Clayton and Mark. Clayton and Mark asked Mr. Denney to call Ayres the next morning to discuss various options for the reissuance of SPS stock to Clayton. Mr. Denney tape-recorded his subsequent telephone conversations with Clayton and Ayres about their plans for the reissuance of SPS stock to Clayton.

Clayton and Mark wanted Ayres to take a "friendly lawsuit" down to the courthouse and have an agreed judgment on Clayton's stock ownership entered before the issue was ever addressed by the SPS board. Mr. Denney rejected this plan, and expressed his belief that the issue probably would carry the board of directors

unless Mrs. Smith and Andrew, as majority shareholders, dissolved the board of directors. Clayton wanted Mr. Denney to review the various options with Ayres, but not to mention anything about the plan to anyone else, including fellow board member Ira Tobolowsky. As stated by Clayton to Mr. Denney, "before we settle on an option, I want it reviewed with [Ayres], to get his input, to make certain that we're not encumbering ourselves in some way that we can avoid."

When Mr. Denney insisted that the matter be fully discussed with the SPS board of directors, Clayton outlined the problems of advance notice:

> *Clayton J. Smith*: I don't have any problem with the board. There's only one fly in the ointment, and that's Andy. And Andy, even though crazy, is not stupid. And he's pretty well informed on legal matters. . . . *I need to talk to Jack.* I want to delve into some legal technicalities with him. . . . You see, I'm a layman right now, but in lay point of view, *I have a question of Jack Ayres* of what type of exposure we have by allowing the board of directors to vote on it, and then going down to the courthouse to finalize it. . . . [A]nd I'd just *have to talk to Jack* and see if I'm talking fairy tales or something that's accurate.

On July 19 at approximately 6:30 a.m. Clayton met with Ayres at Ayres' office to flesh out the final details of Ayres' plan for Clayton to get his stock back. Obviously Ayres could not represent Clayton directly, so they needed a friendly and cooperative outside attorney who could serve as the messenger and deliver a demand letter to the SPS board to set the whole process in motion. So

Ayres decided that Clayton would engage Gerry Wren, Esq., a close personal friend of Ayres.

With Clayton sitting right at Ayres' side, at 7:00 a.m. on July 19 Ayres got Mr. Wren on the speaker phone to talk about the claims that Ayres wanted Wren to make on behalf of Clayton against Ayres' own client, SPS. Ayres told Mr. Wren that he (Ayres) wanted a formal written demand letter on behalf of Clayton so that he (Ayres) could present the letter and the stock issue to the SPS board at its July 22 meeting.

Friday, July 22 arrived, but the demand letter from Mr. Wren didn't. On that day Mr. Wren had left town on a personal matter; was out of contact with his office; and had not as yet prepared the demand letter requested by Ayres. Upon being informed that Mr. Wren had left town without preparing the requested demand letter, Ayres decided that he would prepare the demand letter on his own. So Ayres dictated a phony "demand letter" to himself, as counsel for SPS, demanding that the 1977 stock redemption transaction be rescinded, and that the repurchased shares of SPS stock be returned to Clayton. However, Ayres' demand letter to himself was typed on the letterhead of another law firm (Brice & Barron) over the purported signature of Gerry N. Wren, as ostensible counsel for Clayton (the "Wren Letter"). Further, to be certain to seal the fate on the reissuance of SPS stock to Clayton, Ayres inserted a bogus 5:00 p.m. deadline in the demand letter to himself that had never been discussed with Mr. Wren, Clayton or anybody else.

At the July 22 board meeting Ayres presented the Wren Letter to the directors and doggedly argued that if

the SPS stock was not returned to Clayton, Clayton would prevail in a lawsuit for actual and punitive damages. Ayres strongly recommended to the SPS board that they capitulate to the demands made in the Wren Letter, but at no time did Ayres disclose that he contrived the whole Wren Letter scheme.

Ayres stated in the demand letter to himself that:

> Unless an agreement in principle has been reached between my client and your client on mutually agreed terms before the close of business today at 5:00 p.m., I have been instructed to proceed with suit. It has been my advice to my client that if suit is filed no further settlement efforts should be undertaken.

After the Wren Letter was distributed to the board members Ayres told the SPS board that *"[Mr. Wren's] letter embodies some things that he [Mr. Wren] has not said to me by phone."* But Ayres dictated the letter, not Mr. Wren. According to Mr. Tobolowsky, "Jack Ayres made an impassioned and compelling argument to the Board of Directors that we should vote to give Clayton back his stock", and "Mr. Ayres made me and the other directors . . . very concerned about the potential for individual liability unless the directors voted to rescind the 1977 Transaction and return Clayton's stock to him." However, Ayres did not tell the SPS board that he, not Mr. Wren, had inserted the phony 5:00 p.m. deadline in the demand letter, and that he had never discussed any such supposed deadline with Mr. Wren or anybody else.

Paying homage to a false 5:00 deadline that he had imposed himself, Ayres represented to the SPS board:

> The problem that I'm talking about is, I'm talking about is, if you're going to take that action, I think we're going to hurt ourselves more by waiting, because *I have until 5:00 today,* that's two and a half hours, *to call Wren and tell him,* and I – all I'm saying is, whatever you do, I don't want to be left in the middle of this thing with it hanging, because otherwise you're going to get the worst of both worlds. You're going to get sued and you're not going to be able to settle this lawsuit, if he means what he says.

Staring down the barrel of a purported 5:00 deadline, and without time for independent analysis or reflection, the board of directors of SPS acceded to Ayres' demand in the Wren Letter and was tricked into voting 5 to 2 (with two abstentions) to rescind the prior repurchase of Clayton's stock. Mrs. Smith and Andrew (owners of 65% of the stock of SPS) voted against the rescission.

The false authorship of the demand letter was not the boundary of the fraud. Indeed, Ayres never disclosed to the SPS board that (1) the statements made by Ayres in the demand letter to himself were false; (2) the purported 5:00 deadline inserted by Ayres in the demand letter was bogus and was simply used by Ayres to stampede the SPS board into immediate and uninformed action so Andrew and Mrs. Smith would not have time to call a shareholder's meeting to elect a new slate of directors; (3) all of Clayton's 5 year 10 month old claims were barred by limitations; and (4) the claims of Clayton were concocted by Ayres as a tool to get the SPS board to reissue stock to Clayton and to remove Andrew and Mrs. Smith from a position of control with the Company.

The fraudulently induced July 22, 1983 resolution of SPS acknowledged the receipt of what appeared to be a legitimate demand letter prepared by what appeared to be Clayton's independent counsel, and noted the existence of what appeared to be a real and definite 5:00 p.m. deadline to take action on the matter before suit would be filed by Clayton. That resolution and the purported rescission of the 1977 stock redemption transaction diluted the stock ownership of Andrew and Mrs. Smith from 65% to 48%, and immediately placed Clayton and Mark in control of SPS. Thereafter, corporate raiders Clayton and Mark used SPS as their personal fiefdom; looted the corporate coffers; and wasted millions of dollars in corporate assets.

But the inter-family squabble continued over ownership and control of SPS. When it became apparent that Andrew would not relent in his efforts to restore competent management to SPS, on October 31, 1983 Ayres had SPS add Andrew as an additional party defendant to a lawsuit styled *Smith Protective Services, Inc. v. Cimaglia, et al.*, a suit that Andrew previously had Ayres initiate over three years earlier which was still pending in Judge Dee Brown Walker's court.

There was no legal or factual basis for adding Andrew as a party-defendant to the *Cimaglia* suit. In fact, Andrew was only added as a party-defendant to the *Cimaglia* suit under trumped-up allegations of a conspiracy with the Cimaglias so that Ayres could arrange to have Andrew brought before Judge Dee Brown Walker for the very reasons summarized in *Browning v. Navarro*, 826 F.2d 335, 345 (5th Cir. 1987).

In January of 1984 Andrew discovered that Ayres was the true author of the Wren Letter and that Ayres, Clayton and Mark had conspired to reissue SPS stock to Clayton. After confronting Clayton with this discovery, Ayres immediately obtained an interlocutory default judgment against Andrew in the *Cimaglia* suit (Judge Dee Brown Walker's court), which included a judicial declaration of Clayton's stock ownership in SPS, even though no such request was made in any of the underlying pleadings and Clayton was not even a party to the suit. Thereafter, Ayres obtained from former Judge Walker a "nunc pro tunc" judgment which not only purported to establish Clayton as a shareholder in SPS, but it also purported to completely divest Andrew as a shareholder in SPS. *See Smith Protective Services v. Martin*, 711 S.W.2d 675, 676-79 & 681-82 n. 1 (Tex.App. – Dallas 1986, no writ). As admitted by Ayres when he first hatched the whole fraudulent scheme:

> I'm simply saying that – that the idea of litigation . . . lends an air of finality to it that might help us insofar as Andrew is concerned, because it's my belief that ultimately, . . . when all these things come to pass, . . . *I think Andrew will probably end up suing all of us.* . . . And so therefore, . . . *I'm simply suggesting that [litigation] mechanism as a protective device.*

In reliance on the representations of Ayres about the supposedly meritorious claims of Clayton which were supposedly not barred by limitations, and which supposedly had to be acted on by 5:00 that day, on July 22, 1983 SPS reissued 26% of its stock to Clayton. Had the disinterested members of the SPS board known that there was any collusion between Ayres and Clayton or Mark

pertaining to the claims of Clayton, the board would *not* have voted in favor of the reissuance of SPS stock to Clayton. Further, had the members of the SPS board known that Clayton's claims were either not meritorious in fact, or barred by limitations, the SPS board would *not* have voted in favor of the reissuance of SPS stock to Clayton. In addition, had the members of the SPS board known that there was no real 5:00 deadline as represented by Ayres, the board would *not* have voted in favor of the reissuance of SPS stock to Clayton, but would have voted in favor of an extension so the allegedly "urgent" matter could be investigated and researched further.

Under fear of personal liability, and with the belief that the 5:00 deadline was a true and serious deadline imposed by Clayton's independent attorney, the SPS board was stampeded into reissuing stock to Clayton by the close of business on July 22, 1983. The false 5:00 deadline had accomplished the desired result.

Andrew filed this individual and derivative securities fraud suit on December 31, 1985. Andrew alleged that the Defendants' fraudulent conspiracy was in violation of (a) § 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. § 78j(b)) and Rule 10b-5 promulgated thereunder (17 CFR § 240.10b-5) ("Rule 10b-5") and (b) § 1962(b) of the Racketeer Influenced and Corrupt Organizations Act (18 U.S.C. §§ 1961 *et seq.*), and also constituted fraud, civil conspiracy, tortious interference with corporate governance rights, and breach of fiduciary duties under the common law of Texas. The Defendants' motions to dismiss were granted, in part, by the lower court on March 18, 1987. In addition to dismissing Plaintiff's federal claims, the district court dismissed Plaintiff's pendent

claims because the district court was of the erroneous belief that there was no federal cause of action upon which the pendent claims could attach.

Upon the prior appeal, the Fifth Circuit affirmed the dismissal of Plaintiff's individual federal securities fraud claim and RICO claim; affirmed the dismissal of the conspiracy claims against Clayton and Mark; but "reverse[d] the dismissal of the derivative claim" against Ayres. *Smith v. Ayres*, 845 F.2d 1360, 1361 (5th Cir. 1988).[3] On December 13, 1989 Andrew and his mother settled their claims against SPS, Clayton and Mark, and executed an agreement reflecting the terms of the settlement. As part of the settlement, SPS agreed to "assign and convey to Andrew" its claims or causes of action against Ayres, and permitted Andrew "the right to bring [suit] in the name of the corporation for such claims, including the right to substitute the name of the corporation for the plaintiff in the pending derivative suit now filed in the name of Andrew L. Smith."[4]

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[3] At the time of the prior appeal, neither Plaintiff nor the Fifth Circuit were aware of the tape recorded conversations between Mr. Denney and Ayres and Clayton (Px 2) which confirmed the details of the conspiracy among Ayres, Clayton and Mark to reissue 26% of SPS stock to Clayton and thus shift control of SPS from Andrew and his mother to Clayton and Mark.

[4] Rule 25(c), Fed.R.Civ.P., provides that when there has been a transfer or assignment of an interest in a case, "the action may be continued by or against the original party, unless the court upon motion directs the person to whom the interest is transferred to be substituted in the action or joined with the original party." As noted in 7C Wright, Miller & Kane, *Federal Practice and Procedure* § 1958 p. 555 (1986), "[t]he most

Upon remand, Ayres again moved to dismiss the Complaint, which was granted by the district court on April 12, 1991. On November 23, 1992 the Fifth Circuit issued its Opinion affirming the dismissal of Plaintiff's claims on the basis of two fact-sensitive inquiries *not* argued by the Defendant or relied upon by the district court, and for which Plaintiff was not accorded a full and fair opportunity to provide controverting evidence.

## REASONS FOR GRANTING THE WRIT

As part of the settlement of Andrew's claims against SPS, Clayton and Mark, SPS expressly assigned its claims against Ayres to Andrew and granted Andrew the right to sue as assignee of such claims. The trial court, however, dismissed Plaintiff's complaint, "ruling that Rule 10b-5 securities fraud actions are not assignable." (A3). The Fifth Circuit affirmed the decision of the trial court by applying a novel fact-sensitive test gleaned from *Blue Chip Stamps v. Manor Drug Store*, 421 U.S. 723 (1975). The question of the assignability of a Rule 10b-5 securities fraud claim is an important question of federal law which has not been, but should be, settled by this Court.

Further, the court of appeals affirmed the district court's dismissal of Plaintiff's claims based on two fact-sensitive inquiries neither argued by the Defendant nor utilized by the district court in ruling that Andrew could not proceed as the assignee of SPS' securities fraud

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significant feature of Rule 25(c) is that it does not require that anything be done after an interest has been transferred."

claims. Plaintiff was never accorded the opportunity to develop facts relevant to those two allegedly dispositive fact-sensitive inquiries. The sua sponte "findings of fact" by the court of appeals denied Plaintiff his day in court as to a disputed part of the case on which the trial court has never ruled, in conflict with this Court's decisions in *Fountain v. Filson*, 336 U.S. 681, 683 (1949); *Florida Lime and Avocado Growers, Inc. v. Paul*, 373 U.S. 136, 156 (1963); and *Byrd v. Blue Ridge Rural Electric Cooperative*, 356 U.S. 525, 533 (1958).

Finally, both the district court and the Fifth Circuit refused to acknowledge the pendency of Plaintiff's pendent claims. In effect the Fifth Circuit ruled that unless a court of appeals expressly remands a plaintiff's pendent claims, the pendent claims are fragmented from the remanded federal question claim, and are not again before the district court along with the remanded federal question claim. The question of the power of the district court to entertain a plaintiff's pendent claims along with the expressly remanded federal question claim is an important question of federal law which has not been, but should be, settled by this Court.

## I. THE POLICY CONCERNS OF *BLUE CHIP STAMPS* DO NOT APPLY TO THE ASSIGNABILITY OF RULE 10b-5 CLAIMS BY A DEFRAUDED SELLER OF SECURITIES

Ayres argued in the district court and on appeal to the Fifth Circuit that "claims arising under Rule[] 10b-5 are personal to the injured party", and as such are not assignable. The district court misconstrued the nature of

Plaintiff's claims and ruled that "[Andrew] may not sue as the assignee of the other shareholders' derivative claims." (A17 n.*). The Fifth Circuit disregarded both of those arguments, and affirmed the dismissal of Plaintiff's claims by applying a novel fact-sensitive test gleaned from *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975) to invalidate the assignment of SPS' securities fraud claims to Andrew. (A6-9).

As part of the settlement agreement between Andrew and SPS, "SPS expressly assigned any and all claims against Ayres to Andrew and granted Andrew the right to sue as assignee of such claims." (A2). While a Rule 10b-5 claim must be predicated on an actual purchase or sale of securities as required by *Blue Chip Stamps*, 421 U.S. at 731, so long as the assignor has *Blue Chip Stamps* standing, the express assignee of a Rule 10b-5 claim has *Blue Chip Stamps* standing as well. *AmeriFirst Bank v. Bomar*, 757 F.Supp. 1365, 1370-72 (S.D.Fla. 1991); *Gardner v. Surnamer*, 608 F.Supp. 1385, 1390 (E.D.Pa. 1985); *see, generally*, Note, *Express Versus Automatic Assignment of Section 10(b) Causes of Action*, 1985 Duke L.J. 813, 823 & 828-30 (1985) ("*Duke L.J.*"). Accordingly, to determine the standing of Andrew as assignee, the Court need look no further than the standing of the assignor, SPS.

The federal securities statutes contain no specific provision regarding the assignment of a cause of action under Rule 10b-5. 3 L. Loss *Securities Regulation* p. 1817 (2d Ed. 1961). In the absence of a specific statutory directive, whether a federal statutory claim can be assigned is governed by the federal common law. *Id.; Lowry v. Baltimore & Ohio R.R. Co.*, 707 F.2d 721, 727-28 (3d Cir. 1983) (en banc) (Garth, J. concurring); *cf. Smith v. No. 2*

*Galesburg Crown Finance Corporation*, 615 F.2d 407, 413 (7th Cir. 1980); *Spiller v. Atchison, T. & S.F. Ry. Co.*, 253 U.S. 117, 135 (1920). Although a fraud action personal in nature (such as seducement) may not be assignable, a fraud claim is assignable where it is regarded as an injury to property. *Comegys v. Vasse*, 26 U.S. 193, 213 (1828); *see, generally*, 6A C.J.S. *Assignments* § 40 p. 649 (1975); *Duke L.J.* pp. 815-18. The federal common law is that a Rule 10b-5 claim by a defrauded corporate seller of securities "is not one personal [but rather] is as a matter of law an injury to property." *Hooper v. Mountain States Securities Corporation*, 282 F.2d 195, 206-07 (5th Cir. 1960). Accordingly, an express assignment of a Rule 10b-5 claim by a defrauded corporate seller of securities is effective. *Id.*; *Lowry*, 707 F.2d at 726 n. 7 (Garth, J., concurring) (citing cases); *AmeriFirst*, 757 F.Supp. at 1372; *Gardner*, 608 F.Supp. at 1390.

The "purchase or sale" requirement of *Blue Chip Stamps* is not a barrier to Andrew's standing as assignee of the Rule 10b-5 claims of SPS against Ayres. As previously decided by the Fifth Circuit, SPS was a defrauded seller of securities with *Blue Chip Stamps* standing. *Smith v. Ayres*, 845 F.2d at 1364 & n. 14.

The concern of this Court in *Blue Chip Stamps* was not whether an actual defrauded seller of securities could assign its Rule 10b-5 claims. *Gardner*, 608 F.Supp. at 1392-93; *AmeriFirst*, 757 F.Supp. at 1372. Rather, this Court in *Blue Chip Stamps* limited Rule 10b-5 plaintiffs to those who actually purchased or sold securities based on the defendant's deceit (as opposed to those who claimed that they would have bought or sold securities but didn't) because of concern over "what is and is not manageable

in the litigation of facts. . . . " *Virginia Bankshares, Inc. v. Sandberg*, ___ U.S. ___, ___, 111 S.Ct. 2749, 2757 (1991).

Without limiting Rule 10b-5 plaintiffs to actual purchasers or sellers of securities, a plaintiff would be free to dream up hypothetical securities transactions that he allegedly would have made but for the defendant's deceit. *Blue Chip Stamps*, 421 U.S. at 743. With those hypothetical non-transactions, the plaintiff's version of what he would have bought or sold would not be subject to objective verification, and the jury would be forced to decide "hazy issues of historical fact the proof of which [would depend] almost entirely on oral testimony." *Id.*

These policy concerns over "what is and is not manageable in the litigation of facts" are not implicated when an actual defrauded seller of securities with concrete proof of the sale (such as SPS) expressly transfers its securities fraud claims to an assignee. In other words, the *Blue Chip Stamps* policy concerns are not implicated where there is an actual sale of securities. *AmeriFirst*, 757 F.Supp. at 1372; *Gardner*, 608 F.Supp. at 1393. Accordingly, so long as the assignor has *Blue Chip Stamps* standing, an express assignee of those claims has standing under Rule 10b-5 as well.

## II. THE FIFTH CIRCUIT ERRONEOUSLY AFFIRMED THE RESULT OF THE DISTRICT COURT BASED ON TWO FACT-SENSITIVE CONSIDERATIONS WHICH WERE NOT ARGUED BY THE DEFENDANT OR UTILIZED BY THE DISTRICT COURT IN INVALIDATING THE ASSIGNMENT OF SPS' RULE 10b-5 CLAIMS

The district court dismissed Plaintiff's securities fraud claims by granting the Defendant's supplemental

motion to dismiss. (A2, 11 & 19). In affirming the dismissal of this case, the Fifth Circuit ruled that the two policy concerns discussed in *Blue Chip Stamps* to limit standing for Rule 10b-5 actions to actual purchasers or sellers of securities guided its decision here that SPS could not assign its Rule 10b-5 claims to Andrew. (A6-9). Those two policy factors were (1) concern about strike suits or nuisance suits; and (2) concern over evidentiary problems where a plaintiff must depend on his own self-serving testimony to prove his case. (*Id.*).

These factors were not argued by Ayres or utilized by the district court in ruling that Andrew could not proceed as the assignee of SPS' securities fraud claims. The district court made no finding that Plaintiff's securities fraud suit against Ayres lacked merit or that Plaintiff's proof was dependent upon Andrew's self-serving testimony. Indeed, the district court never even discussed the alleged lack of merit of the securities fraud claims against Ayres or Plaintiff's supposed dependence upon the self-serving testimony of Andrew to prove Ayres' fraudulent conduct.

Rather, Ayres argued in the district court that "claims arising under Rule[] 10b-5 are personal to the injured party", and as such are not assignable.[5] After we pointed

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[5] Without supporting evidence, Ayres made the conclusory statement that this case was a "strike suit" in connection with his argument that Andrew was not an adequate representative to proceed with a *derivative* suit under Fed.R.Civ.P. 23.1. However, Ayres never argued, and the district court never ruled, that the Rule 10b-5 claim of SPS against Ayres was not assignable to Andrew because the underlying suit was supposedly a strike

out to the district court that the Fifth Circuit in *Hooper*, 282 F.2d at 206-07 had ruled just the opposite, the district court dismissed Plaintiff's complaint by ruling that "[Andrew] may not sue as the assignee of the other shareholders' derivative claims." (A17 n.*). Moreover, the district court expressly stated that its judgment of dismissal was entered "[f]or the reasons stated in the Court's April 12, 1991 Memorandum Order granting the [Defendant's] Supplemental Motion to Dismiss. . . . " (A20). After we advised the district court that Andrew never contended that he could proceed with this suit "as the assignee of the other shareholders' derivative claims", the district court denied Plaintiff's motion for reconsideration, without explanation, even though Ayres could not muster a response to the motion.

Upon appeal we pointed out to the Fifth Circuit that Andrew never contended that he could proceed with this suit "as the assignee of the other shareholders' derivative claims." The Fifth Circuit, however, affirmed the result of the district court *not* because "claims arising under Rule 10b-5 are personal to the injured party", and as such are not assignable (as argued by Ayres); and *not* because "[Andrew] may not sue as the assignee of the other shareholders' derivative claims" (as decided by the district court). Rather, the Fifth Circuit affirmed the district court's dismissal of Plaintiff's suit based on two fact-sensitive factors, neither of which were argued by the Defendant or relied upon by the district court in determining that Andrew could not proceed as the assignee of

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suit peculiarly dependent upon the testimony of Andrew to prove the claims.

SPS' securities fraud claims, and neither of which Plaintiff was accorded the opportunity to controvert in the district court.

Indeed, in affirming the district court's decision, the Fifth Circuit ignored the merits of Plaintiff's claims and looked solely to the animosity that Andrew felt toward Ayres to erroneously conclude that "this action bears all the hallmarks of a strike or nuisance suit. . . . " (A8). However, a strike suit or a nuisance suit is not based on the animosity or personal antagonisms a plaintiff has for a defendant. *Cf. Vanderbilt v. Geo-Energy Ltd.*, 590 F.Supp. 999, 1001 (E.D.Pa. 1984) (residual contentiousness and discordant relationship between plaintiff and defendant may inspire the plaintiff to be an even more forceful advocate). Rather, a strike suit or a nuisance suit is based on the manifest lack of merit of the underlying claim. As noted by this Court in *Surowitz v. Hilton Hotels Corporation*, 383 U.S. 363, 371 (1966), a strike suit is a suit

> by people who might be interested in getting quick dollars by making charges without regard to their truth so as to coerce corporate managers to settle worthless claims in order to get rid of them.

*See, also, Cohen v. Beneficial Loan Corp.*, 337 U.S. 541, 548 (1949).

Further, the Fifth Circuit ignored the transcript of the tape recorded conversations between Mr. Denney (the former president of SPS) and Clayton and Ayres (Px 2) (which proves the scheme to reissue SPS stock to Clayton); ignored the transcript of the tape recorded July 22, 1983 board of directors' meeting (Px 37) (which proves

the masterful execution of the stock fraud scheme by Ayres); and ignored the affidavit (Px 34) and deposition (Px 38) of Ira Tobolowsky, Esq. (which corroborate the allegations in the Complaint) to erroneously conclude that "Andrew must necessarily rely heavily on his own 'self-serving testimony' " to prove the merits of this case. (A9).

While an appellate court may affirm the decision (if correct) of a trial court even though the trial court relied on the wrong reason in reaching its result (*Fountain v. Filson*, 336 U.S. 681, 683 (1949); *Heirs of Fruge v. Blood Services*, 506 F.2d 841, 844 n. 2 (5th Cir. 1975)), an appellate court may not do so where the aggrieved party was not accorded a "full and fair opportunity to develop facts relevant to the decision." *Id.* Since Ayres never argued, and the district court never ruled, that the securities fraud claims of SPS were not assignable to Andrew because this was supposedly an unmeritorious strike suit and the proof of Ayres' securities fraud was supposedly peculiarly dependent upon Andrew's self-serving testimony, we were never accorded a "full and fair opportunity to develop facts relevant to the decision."

The Fifth Circuit's affirmance based on two fact-sensitive factors which were not argued by the Defendant or utilized by the district court in invalidating the assignment of SPS' Rule 10b-5 claims to Andrew deprived Plaintiff of the opportunity to develop facts relevant to the Fifth Circuit's decision. Where this "full and fair opportunity" was not made available, "the proper resolution of the appeal is not affirmance but remand." *Heirs of Fruge*, 506 F.2d at 844 n. 2. At no time were we accorded the opportunity to develop facts relevant to those two

allegedly dispositive fact-sensitive inquiries. Accordingly, the sua sponte "findings of fact" by the Court of Appeals denied Plaintiff his day in court as to a disputed part of the case on which the trial court has never ruled. *Florida Lime and Avocado Growers, Inc. v. Paul*, 373 U.S. 136, 156 (1963); *Byrd v. Blue Ridge Rural Electric Cooperative*, 356 U.S. 525, 533 (1958).

## III. THE FIFTH CIRCUIT'S DECISION IS NOT ONLY WRONG IN THIS CASE, IT IS BAD LAW

In the absence of a statutory directive to the contrary (*Spiller v. Atchison, T. & S.F. Ry. Co.*, 253 U.S. 117, 135 (1920); 6A C.J.S. *Assignments* § 42 p. 652 (1975)), the validity of an assignment of a fraud claim is based on an objective standard: the "property" versus "personal" aspect of the claim. *Hooper*, 282 F.2d at 206-07; *Comegys v. Vasse*, 26 U.S. 193, 213 (1828); *see, generally*, 6A C.J.S. *Assignments* § 40 p. 649 (1975); *Duke L.J.*, pp. 815-18. Under the Fifth Circuit's novel approach, each district court judge will be faced with a motion to dismiss in each case where there is an assigned securities fraud claim, with each defendant contending that the suit is nothing more than an unmeritorious strike suit dependent upon the plaintiff's self-serving testimony to prove the claim.

Is there supposed to be an evidentiary hearing? How much animosity that the plaintiff feels for the defendant will be too much and thus serve to invalidate the assignment? Further, who bears the burden of showing that the Rule 10b-5 claim is peculiarly dependent upon the plaintiff's self-serving testimony? And how much corroborating evidence is required? Is one witness enough? How

much documentary evidence must be shown? In short, every case involving an assignment of a securities fraud claim would lead to a claim by the defendant that the assignment was not effective because the suit is nothing more than an unmeritorious strike suit peculiarly dependent upon the self-serving testimony of the plaintiff to prove the claim.

The Fifth Circuit's decision only beclouds an aspect of 10b-5 litigation which deserves clarification and elucidation. *See Lowry v. Baltimore & Ohio R.R. Co.*, 707 F.2d 721 (3d Cir. 1983) (*en banc*), *cert. denied*, 464 U.S. 893 (1983). With the power of the district court to require a bond or security for costs and expenses (including attorney's fees), and the reality of sanctions under Fed.R.Civ.P. 11, there are already sufficient procedures in place to handle the wrongful prosecution of an unmeritorious strike suit. The Fifth Circuit's decision only adds an unnecessary layer of uncertainty.

Ultimately the bad law reflected by the Fifth Circuit's opinion will be visited upon many of the trial and appellate judges in our federal court system. The slippery slope subjective test announced by the Fifth Circuit is not only wrong under the facts of this case, it is bad law.

## IV. THE FIFTH CIRCUIT AND THE DISTRICT COURT REFUSED TO ACKNOWLEDGE THE PENDENCY OF PLAINTIFF'S PENDENT CLAIMS

Neither the Fifth Circuit in *Smith v. Ayres I* nor the district court in its prior dismissal of this case reached the merits of Plaintiff's pendent state law claims. Rather, in March of 1987 there was the conditional dismissal of

Plaintiff's pendent claims by the district court for lack of jurisdiction because the district court was of the erroneous belief that there was no federal claim upon which the pendent claims could attach. The district court in its prior reversed order simply ruled that:

> The remaining claims asserted by [Plaintiff] arise only under state law. Since the court has determined that the securities fraud claim and RICO claim should be DISMISSED, the pendent claims must also be DISMISSED since there is no basis for federal jurisdiction.

Because of the conditional nature of the prior dismissal of the pendent claims, the Fifth Circuit's prior reversal of the condition in *Smith v. Ayres I* necessarily removed the basis by which the lower court dismissed the pendent claims. The reversal of the dismissal of one of the federal claims necessarily reverses the dismissal of the pendent claims for lack of federal jurisdiction. *Donahue v. Windsor Locks Board of Fire Commissioners,* 834 F.2d 54, 59 n. 2 (2d Cir. 1987); *Sun Savings & Loan Association v. Dierdorff,* 825 F.2d 187, 189 n. 1 (9th Cir. 1987); *Ouaknine v. MacFarlane,* 897 F.2d 75, 84 (2d Cir. 1990).

Although the pendency of Plaintiff's pendent claims was expressly brought to the district court's attention, the district court refused to acknowledge the existence of Plaintiff's pendent claims and simply dismissed Plaintiff's Complaint. Here the Fifth Circuit erroneously ruled that:

> Andrew's state law claims are not properly before this court, having been dismissed earlier in the action and such dismissal upheld by a prior panel. *See Smith v. Ayres,* 845 F.2d at 1366

> (dismissal of all claims affirmed, save only the derivative claim).

(A10 n. 2). But the district court's conditional dismissal of Plaintiff's pendent claims was not affirmed in *Smith v. Ayres I*, whether at page 1366 or any other page in the prior Fifth Circuit opinion. Accordingly, upon remand the district court was reinvested with complete judicial authority to hear the whole case – the expressly remanded federal securities fraud claim *and* the pendent state law claims expressly set forth in Plaintiff's complaint.

In effect the Fifth Circuit has ruled that if the prior appellate decision does not expressly remand the pendent state law claims, then the whole constitutional case is fragmented, with only the expressly remanded federal question claim, and not the "whole case", being remanded to the district court for consideration. The decision of the Fifth Circuit runs contrary to the basic notion of pendent jurisdiction which encourages the federal courts to hear the whole case where the federal and state claims arise from a common nucleus of operative facts.

> Pendent jurisdiction, in the sense of judicial *power*, exists whenever there is a [federal question] claim . . . and the relationship between that claim and the state claim permits the conclusion that the entire action before the court comprises but one constitutional "case." . . . But if, considered without regard to their federal or state character, a plaintiff's claims are such that he would ordinarily be expected to try them all in

> one judicial proceeding, then, assuming substantiality of the federal issues, there is *power* in federal courts to hear the whole.

*United Mine Workers v. Gibbs*, 383 U.S. 715, 725 (1966). The justification for pendent jurisdiction "lies in considerations of judicial economy, convenience and fairness to litigants. . . . " *Id.* at 726. *See, also, Carnegie-Mellon University v. Cohill*, 484 U.S. 341, 349 (1988).

Ayres argued that Plaintiff's pendent state law claims were not again before the district court upon the prior reversal because Plaintiff did not specifically raise on appeal any error in connection with the district court's conditional dismissal of the pendent claims. However, a district court's dismissal, without prejudice, of a party's pendent claims is vested in the sound discretion of the trial court. *Gibbs*, 383 U.S. at 726. Accordingly, the district court's conditional dismissal of Plaintiff's pendent state law claims upon the dismissal of Plaintiff's federal claim was not clearly erroneous in and of itself, thus leaving no issue to appeal on that point.

Upon remand, however, Plaintiff's Second Amended Complaint contained both the expressly remanded derivative Rule 10b-5 claim, as well as the unadjudicated pendent state law claims against Ayres for fraud, civil conspiracy, tortious interference with the corporate governance rights of SPS, and breach of fiduciary duties. Although the district court clearly had the power to adjudicate Plaintiff's pendent state law claims against Ayres (*Gibbs*, 383 U.S. at 727), both the district court and the Fifth Circuit refused to acknowledge the pendency of Plaintiff's pendent claims.

Finally, the Fifth Circuit's opinion is contrary to the policy of handling pendent claims so that they are not barred by limitations. *See Carnegie-Mellon*, 484 U.S. at 351-52. Here, however, the net effect of the Fifth Circuit's treatment of the pendent claims is to leave Plaintiff with meritorious state law claims against Ayres subject to a plea of limitations.

## CONCLUSION

Based on the foregoing, we respectfully request that the Court grant this Petition for Writ of Certiorari, and that the Court then reverse *per curiam*, without further ado, the order and judgment of the Fifth Circuit. Otherwise, this case should be scheduled for plenary briefing and argument.

Respectfully submitted,

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DATED: March 19, 1993.

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## APPENDIX A

**Andrew L. SMITH, individually and derivatively on Behalf of Smith Protective Services, Inc., Plaintiff-Appellant,**

**v.**

**R. Jack AYRES, et al., Defendants,**

**R. Jack AYRES, Defendant-Appellee.**

**No. 91-1734.**

United States Court of Appeals,
Fifth Circuit.

Nov. 23, 1992.

F. Dean Armstrong, Flossmoor, Ill., for plaintiff-appellant.

Edwin E. Wright, III, Stradley & Wright, Dallas, Tex., for Ayres.

Appeal from the United States District Court for the Northern District of Texas.

Before WISDOM, REYNALDO G. GARZA, and JONES, Circuit Judges.

EDITH H. JONES, Circuit Judge:

Andrew Smith appeals from the district court's dismissal of his class action [sic] securities fraud claim and his stockholder derivative action. We affirm the trial court's decision in all respects.

### BACKGROUND

The instant appeal is but another chapter in a protracted internecine feud among Coralie Smith (mother of

Andrew, Clayton, and Mark), Andrew Smith, Clayton Smith, and Mark Smith, principals or former principals of Smith Protective Services (SPS). At this point, Andrew is pursuing Jack Ayres, General Counsel and Director [sic] of SPS, in a derivative suit and as assignee of the company's Rule 10b-5 securities fraud claims. A fuller recitation of the facts may be found in the earlier opinion, in which this court reversed the first dismissal of the shareholder derivative claim and affirmed the dismissal of related claims. *Smith v. Ayres*, 845 F.2d 1360, 1361-63 (5th Cir.1988).

The trial court originally dismissed Andrew's complaint on the grounds that a state court judgment deprived Andrew of his stock ownership in SPS, thereby defeating his standing to bring a derivative action on behalf of SPS. Because the state court judgment had later been reversed by the Texas Court of Appeals, this court remanded the derivative action for further consideration. On remand, Ayres reasserted his claim that Andrew lacked standing to bring a derivative action on behalf of SPS. The district court granted the supplemental motion to dismiss, ruling that Andrew was not an adequate or proper shareholder representative to bring a class action. [sic] Fed.R.Civ.P. 23.1.

Andrew alternatively claims standing based on his status as a putative assignee of securities fraud claims against Ayres. As part of the settlement agreement between Andrew and SPS (referred to by the parties as the Smith Family Peace Treaty), SPS expressly assigned any and all claims against Ayres to Andrew and granted Andrew the right to sue as assignee of such claims. Andrew retained one of the 10,000,000 shares in SPS.

Under the settlement agreement, Andrew was to have no other benefits of ownership; Andrew could not participate in management, could not vote his share, could not bring other derivative suits, and was obliged to reconvey the single share to SPS if the share became unnecessary to maintain the derivative action against Ayres. In sum, Andrew's single share of stock was granted to him for the sole purpose of generating federal standing in his action against Ayres. The trial court rejected this basis for standing, ruling that Rule 10b-5 securities fraud actions are not assignable.

## STANDING AS A DERIVATIVE PLAINTIFF

In order to bring a derivative action, the shareholder plaintiff must "fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation or association." Fed.R.Civ.P. 23.1. Determining whether the plaintiff meets this standard is firmly committed to the discretion of the trial court, reviewable only for abuse. *Zeidman v. J. Ray McDermott & Co., Inc.*, 651 F.2d 1030, 1040 (5th Cir. Unit A 1981); *see also Larson v. Dumke*, 900 F.2d 1363, 1364 (9th Cir.), *cert. denied*, ___ U.S. ___, 111 S.Ct. 580, 112 L.Ed.2d 585 (1990).

Andrew's current stake in the corporation is infinitesimal; he holds 1/10,000,000 of the authorized shares. More significantly, he receives no cooperation from Mark and Clayton in his persistent litigation efforts against Ayres. Indeed, Mark and Clayton, the remaining two SPS shareholders, vigorously deny the essential allegations that form the basis for this suit, which Andrew must

prove to prevail. The trial court may properly consider the degree of support a would-be shareholder plaintiff will receive from other shareholders in determining the adequacy of representation under Rule 23.1. *See Larson*, 900 F.2d at 1368.

Andrew argues that the test of adequate representation is not whether he can adequately represent all shareholders, but whether he can adequately represent all shareholders similarly situated to himself. Since Mark and Clayton are not similarly situated, he argues that he is a class of one. Only in the rarest instances may there be a shareholder derivative action with a class of one. Such circumstances were manifest in *Larson*, in which the plaintiff was the original owner and founder of a pizza franchise operation who had sold most of his interest to others, but retained an interest of almost 25 percent. He opposed the institution of an Employer Stock Option Plan by some of the new owners and was the only stockholder who elected not to participate.

Larson filed a derivative action to force rescission of the plan, but was not joined by any other shareholders because they would lose money should the suit succeed. With great difficulty, and taking care to limit its holding to the narrow and precise facts before it, the Ninth Circuit allowed Larson to proceed as a class of one. *Larson*, 900 F.2d at 1369. Andrew's situation is entirely distinct. Andrew was not the individual who created, nurtured, and operated SPS from inception. He retained only a negligible interest in SPS. Moreover, in *Larson*, the other shareholders were opposed to Larson's suit because Larson's success would ultimately injure them financially whether or not it benefitted the corporation. Such is not

the case here. Mark and Clayton, principals and owners of virtually 100% of SPS, simply fundamentally disagree with Andrew on what is good for the corporation.

A plaintiff in a shareholder derivative action owes the corporation his undivided loyalty. The plaintiff must not have ulterior motives and must not be pursuing an external personal agenda. Whether or not such a personal agenda exists is determined by the trial court, and we will not reverse its determination absent clear error. In deciding this question, the court may properly consider the amount of the plaintiff's stake in the corporation as balanced against his interest and how the litigation may affect his external interests. *Blum v. Morgan Guaranty Trust Co.*, 539 F.2d 1388, 1390 (5th Cir.1976); *see also Halsted Video, Inc. v. Guttillo*, 115 F.R.D. 177, 180 (N.D.Ill.1987).

Andrew has an unmistakable personal and professional dispute with Ayres. His brief is peppered with vituperative epithets, pugilistic metaphors, and descriptions of Ayres as "satanic" and "evil." Andrew and Ayres are on opposite sides of the emotionally charged feuds between the Browning and the Holloway families. Ayres represents the Brownings' interests and Andrew represents the Holloways' interests. A catalog of the various lawsuits between these two parties and their affiliates would consume well over a full page. *See generally In the Matter of Holloway*, 955 F.2d 1008 (5th Cir.1992); *Browning v. Navarro*, 923 F.2d 377 (5th Cir.1991). While those lawsuits bear no direct relationship to the instant case, they suggest the virulent antagonism Andrew holds for Ayres. The trial court may properly consider the plaintiff's vindictiveness toward the defendant in determining whether

the plaintiff is an adequate representative of the stockholders. *See Davis v. Comed, Inc.*, 619 F.2d 588, 593-94 (6th Cir.1980). For example, Andrew has stated that he is committed to "ruin ten years of [Ayres' life], because I'm going to be sure that Pat Holloway prevails . . . and he – if he thinks this is even the end of the tenth round, I mean we're – we're not even in the first round." As was stated in *Blum*, the trial court should beware allowing a derivative suit to proceed where the "representative could conceivably use the derivative action as 'leverage' in other litigation. . . . " *Blum*, 539 F.2d at 1390. The district court did not abuse its discretion in concluding that Andrew does not qualify as a fair and adequate representative of shareholder interests under Rule 23.1.

## ASSIGNMENT OF SPS'S 10b-5 CLAIM

Andrew also claims standing on the basis of the express assignment of SPS's right to sue Ayres. Andrew argues that the generally accepted rule of non-assignability of Rule 10b-5 claims is not applicable to the instant case because he received a direct and express assignment and does not rely on an automatic assignment which travels with his single share of stock.[1] As far as we can tell, Andrew's is a novel claim. Ayres responds that 10b-5 claims are personal and may never be assigned. Ayres warns of dire consequences if we accept Andrew's argument, suggesting that to allow the assignment to

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[1] Indeed, Andrew's "ownership" of a single share of stock has no bearing on the assignability of the Rule 10b-5 action. His stock share may crack open the door to a derivative action, but the assignment must rise and fall on its own.

create standing would presage the development of a futures market in Rule 10b-5 claims.

The guidepost case determining standing rules for 10b-5 actions is *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 95 S.Ct. 1917, 44 L.Ed.2d 539 (1975). The *Blue Chip Stamps Court* adopted the venerable *Birnbaum* Rule, established in *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956, 72 S.Ct. 1051, 96 L.Ed. 1356 (1952), in which the Second Circuit restricted Rule 10b-5 actions to persons who are either purchasers or sellers of securities. *Blue Chip Stamps*, 421 U.S. at 730-31, 95 S.Ct. at 1917. The *Blue Chip Stamps* decision was intended to tightly restrict the availability of Rule 10b-5 actions. Many courts have relied upon this premise to hold that 10b-5 actions are not automatically assigned when the security is sold. *See, e.g., In re Nucorp Energy Securities Litigation*, 772 F.2d 1486, 1490 (9th Cir.1985); *Soderberg v. Gens*, 652 F.Supp. 560, 564 (N.D.Ill.1987); *In re Saxon Securities Litigation*, 644 F.Supp. 465, 470-72 (S.D.N.Y. 1985); *Rose v. Arkansas Valley Environmental & Utility Authority*, 562 F.Supp. 1180, 1189 (W.D.Mo.1983). Only one court has held an express assignment of a 10b-5 claim to be valid. *AmeriFirst Bank v. Bomar*, 757 F.Supp. 1365, 1371 (S.D.Fla. 1991). The Court of Appeals for the Second [sic] Circuit has opined in dicta that an express assignment does not violate the strict construction philosophy of *Blue Chip Stamps*. *Lowry v. Baltimore & Ohio R.R. Co.*, 707 F.2d 721 (3d Cir.) (*en banc*) (eight member panel produced three opinions, six of the eight judges recognized at least the possibility of an express assignment), *cert. denied*, 464 U.S. 893, 104 S.Ct. 238, 78 L.Ed.2d 229 (1983). *See also*, Note, *Express v. Automatic Assignment of*

*Section 10b Causes of Action*, 1985 Duke L.J. 813, 823 (express assignment is not inconsistent with strict purchase-or-sale rule of *Blue Chip Stamps*).

The *Blue Chip Stamps* decision to narrow Rule 10b-5 standing was based principally on two policy considerations, both of which guide our decision. First, the Court looked to Congressional intent behind section 10(b) of the Securities Exchange Act of 1934. The Court found that Congress was concerned with blackmail, nuisance, and strike suits, and drafted the Act to circumscribe the class of plaintiffs who may sue under the Act for the very purpose of eliminating such suits. 421 U.S. at 740-41, 95 S.Ct. at 1927-28. The Court's second concern centered on the evidentiary problems inherent in allowing a non-purchaser or non-seller to bring a Rule 10b-5 action. 421 U.S. at 741-43, 95 S.Ct. at 1928-29. The Court was particularly concerned that such suits would turn on "self serving testimony . . . , protracted discovery, [and bear] little chance of reasonable resolution by pre-trial process." *Virginia Bankshares, Inc. v. Sandberg*, ___ U.S. ___, ___, 111 S.Ct. 2749, 2765, 115 L.Ed.2d 929 (1991) (citing *Blue Chip Stamps*, 421 U.S. at 742-43, 95 S.Ct. at 1928-29). The district court noted that "a particular concern here is the risk that this derivative action will be used as a weapon in Andrew's arsenal rather than a device for the protection of all shareholders" and that "Andrew's personal antagonisms are a major motivation behind this lawsuit." In sum, this action bears all the hallmarks of a strike or nuisance suit, the very actions which the *Blue Chip Stamps* decision seeks to reduce or eliminate. Moreover, Andrew must tackle potentially insuperable evidentiary obstacles in proving the merits of his case. Mark and

Clinton [sic], the two majority shareholders in SPS, have unequivocally denied the allegations that form the crux of Andrew's suit. Andrew must necessarily rely heavily on his own "self-serving testimony," and the action bears "little chance of reasonable resolution by pre-trial process."

An assignee, Andrew falls squarely within the type of remote purchasers whose 10b-5 actions are discouraged by *Blue Chip Stamps* and later decisions relying thereon. This court has previously held that Andrew was not affected by any fraud because he voted against issuing shares to Clayton, the action complained of in this suit. *See Ayres,* 845 F.2d at 1364. Andrew secured the assignment of SPS's claims against Ayres and maintains "ownership" of a single share of stock for the express purpose of defeating doctrines which otherwise would preclude his standing to bring this action. His hope is in vain; form will not triumph over substance here. *See Goldberg v. Touche Ross & Co.,* 531 F.Supp. 86, 88 (S.D.N.Y.1982) (assignment of 10b-5 action could not be used to defeat federal law prohibiting indemnity actions under Rule 10b-5).

## CONCLUSION

We need not resolve and reserve for another day whether under other circumstances, some Rule 10b-5 claims may be expressly assigned. In this case, however, the trial court did not err in dismissing the claim based upon the purported assignment of the Rule 10b-5 action where the assignment appeared to have been made for

the purpose of creating standing and pursuing a vexatious lawsuit. Nor did the court abuse its discretion in finding that Andrew was not a proper class action [sic] representative.[2] Andrew's request that the case be reassigned on remand to a different district court judge is without merit but in any event mooted by our affirming the judgment of dismissal.

AFFIRMED.

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[2] Andrew's state law claims are not properly before this court having been dismissed earlier in the action and such dismissal upheld by a prior panel. *See Smith v. Ayres*, 845 F.2d at 1366 (dismissal of all claims affirmed save only the derivative claim).

**APPENDIX B**

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF TEXAS
DALLAS DIVISION

| | | |
|---|---|---|
| ANDREW L. SMITH, Plaintiff, | ) | CIVIL ACTION NO. CA 3-85-2628-G |
| VS. | ) | |
| R. JACK AYRES, ET AL., Defendants. | ) | |

MEMORANDUM ORDER

(Filed April 12, 1991)

This case is before the court on the supplemental motion of defendants R. Jack Ayres, Jr., and R. Jack Ayres, Jr., P.C. ("Ayres") to dismiss, for want of standing, the shareholder derivative suit brought against them by plaintiff Andrew L. Smith ("Andrew"). For the reasons stated below, Ayres' motion is granted.

## I. Background

Andrew brought this shareholder derivative action on behalf of Smith Protective Services ("SPS"), a family-owned corporation that specializes in home protection and security services. In 1977, Andrew was the president and chairman of the board of SPS and owned approximately 26 percent of the corporation's stock. The other owners were his mother, Coralie Smith ("Coralie"), 22 percent, and his brothers, Clayton Smith ("Clayton") and Mark Smith ("Mark"), with 26 percent each.

In June, 1977, Andrew accused Clayton of embezzling money from the business and the corporation filed suit. Ayres, as SPS' general counsel and director [sic], represented the corporation. In the settlement of that suit, the corporation released any claim it had against Clayton in exchange for Clayton's agreement to sell his stock back to SPS. After completing the stock redemption, Andrew and Mark each held 35 percent of the outstanding shares, while Coralie held 30 percent. With their combined majority stake, Andrew and his mother had effective control.

Andrew alleges that in 1983 Clayton set about to recover his interest in the company, and enlisted the support of Mark and Ayres. Clayton's plan, according to Andrew, was to force the board to reissue Clayton's shares in the company under the theory that the prior settlement agreement had been obtained by fraud. For this purpose Clayton retained Gerry Wren, a Dallas lawyer. Clayton intended to have Wren send a letter demanding return of his shares.

On July 20, Clayton related his plan to Ira Tobolowsky, another Dallas attorney who served as an SPS director. The next day, July 21, Tobolowsky telephoned Ayres twice to discuss Clayton's demand letter. Tobolowsky later called Wren's office and learned that Wren had left town without sending the letter. In a conference call that included Tobolowsky, Wren's secretary, and Ayres, Tobolowsky told Ayres that Wren had not sent the letter. Ayres then dictated a letter to Wren's secretary. When Wren's secretary learned that the recorder had

failed to record, she called Tobolowsky. Tobolowsky initiated another conference call, and Ayres successfully dictated the letter to another secretary.

Later the same day, Ayres received the demand letter which bore Wren's signature and which was typed on his firm's stationery. Ayres presented the letter to the board of directors and recommended that the board accede to Clayton's demands. Ayres did not disclose, however, that he was the author of the letter. The Board followed Ayres' recommendation by a vote of 7-2 [sic], with only Andrew and Coralie opposed. The decision gave Clayton and Mark a 52% interest in the corporation. According to Andrew, they have used this control to mismanage the corporation and divert corporate assets for personal gain.

When in February 1986, Andrew entered a plea of "no contest" to an indictment alleging cocaine possession, SPS filed suit in state court to divest Andrew of his shares in the corporation under a Texas law that assertedly prohibits felons from owning an interest in a licensed security agency. A Texas district court granted SPS an injunction requiring Andrew to sell his shares back to the corporation. This decision was reversed on October 21, 1987 by the Texas Court of Appeals. The appellate court found that SPS had no standing to seek the injunction because SPS was attempting to enforce a state agency rule that only the agency could enforce.

As originally filed by Andrew, this suit alleged that Clayton, Mark and Ayres violated the antifraud provisions of Rule 10b-5 of the securities laws (Securities Exchange Act of 1934, § 10(b), 15 U.S.C. § 78j(b); Rule 10b-5, 17 C.F.R. § 240, 10b-5) as well as the Racketeer

Influenced and Corrupt Organizations Act, 18 U.S.C. §§ 1961-68 ("RICO"). This court dismissed Andrew's individual 10b-5 claim, reasoning that because Andrew voted against rescission, he could not have relied on the letter and thus could not allege the element of reliance. This court also held that Andrew had no standing to bring a derivative securities claim on behalf of the corporation because of the state court decision divesting Andrew of his shares in SPS; at that time the decision was still pending before the state court of appeals. This court dismissed Andrew's RICO claim for failure to plead two or more predicate acts of racketeering as required by the statute.

On appeal from this court's decision, the Fifth Circuit affirmed the dismissal of Andrew's individual 10b-5 claim as well as the RICO claim. Because the state court of appeals had, while the appeal of this case was pending, reversed the state district court's injunction requiring Andrew to sell his shares back to SPS, the Fifth Circuit reversed this court's dismissal of Andrew's shareholder derivative action and remanded it for further proceedings. Smith v. Ayres, 845 F.2d 1360 (5th Cir. 1988).

## II. Analysis

Rule 23.1 of the Federal Rules of Civil Procedure establishes the pleading requirements for shareholders pursuing derivative actions. The rule also dictates when a shareholder may not sue as a derivative plaintiff to enforce the right of a corporation:

> The derivative action may not be maintained if it appears that the plaintiff does not fairly and

> adequately represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation or association.

An adequate representative must have the capacity to vigorously and conscientiously prosecute a derivative suit and be free from economic interests that are antagonistic to the interests of the class. Larson v. Dumke, 900 F.2d 1363, 1367 (9th Cir.), *cert. denied*, ___ U.S. ___, 111 S.Ct. 580 (1990); Owen v. Modern Diversified Industries, Inc., 643 F.2d 441, 443-44 (6th Cir. 1981); Blum v. Morgan Guaranty Trust Company of New York, 539 F.2d 1388, 1390 (5th Cir. 1976). "Should any 'ulterior' motives of plaintiffs which are inimical to their ability to adequately represent the other shareholders become manifest, the Court is free to make appropriate adjustments." First American Corporation v. Foster, 51 F.R.D. 248, 250 (N.D.Ga. 1970).

A particular concern here is the risk that this derivative action will be used as a weapon in Andrew's arsenal rather than a device for the protection of all shareholders. *Blum*, 539 F.2d at 1390. The three current shareholders in SPS are Andrew, Mark, and Clayton. Of the currently authorized ten million shares of SPS stock, Andrew holds only one share, ostensibly to give him standing to prosecute this suit. Andrew's ability to fairly and adequately represent Mark and Clayton's interest *vis a vis* SPS is questionable, however, in light of the fact that Mark and Clayton were originally named as defendants. In addition, the exhibits and history of this litigation indicate that Andrew, Mark, and Clayton have been struggling for control of SPS for some time, and that Andrew does not

believe SPS can function as a viable business unless he is in control of the corporation.

The record also indicates that Andrew's personal antagonisms are a major motivation behind this lawsuit. Andrew and Ayres represented opposing sides in a series of lawsuits, regarding which Andrew testified:

> . . . I decided, you know, since, you know, he [Ayres] was going to ruin five years of my life that I'm going to ruin ten of his, because I'm going to be sure that Pat Holloway prevails. And anybody who would just spitefully try to put one on me like this, it's not going to be over with until it's over with. And he – if he thinks this is even the end of the tenth round, I mean we're – we're not even first round.

Deposition of Andrew L. Smith at 185-86 (Exhibition 31 to Ayres' Supplemental Motion to Dismiss).

Besides expressing a desire to use this suit as another "round" in his personal boxing match, Andrew in his deposition repeatedly refers to Ayres as insane, evil, or possessed by a satanic spirit. *Id.* at 187, 270.

The extraneous, personal motivations behind this lawsuit clearly outweigh any benefit Andrew seeks to confer upon Mark and Clayton. Andrew seems to recognize as much in his responsive brief, arguing that rather than representing the interests of Mark and Clayton, he represents the interests of "members similarly situated" to himself, which – under the circumstances here – is a set whose only member is Andrew: "Since Andrew is the only shareholder similarly situated, he by necessity fairly and adequately represents the interests of himself and meets the qualifications of Rule 23.1" (Plaintiff's

Response at 19). If the court were to accept this reasoning, Rule 23.1 would be rendered meaningless, for any plaintiff in a derivative suit could circumvent the fair and adequate representation requirement by claiming to represent him- or herself as the only member similarly situated.

In *Owen*, 643 F.2d at 443-44, the Sixth Circuit affirmed a district court's holding that a plaintiff in a derivative suit could not fairly and adequately represent other shareholders when he owned only 24 shares whose value did not exceed $21.00, but also owned debentures of the same corporation with a face value of $34,900. By the same token, Andrew – a plaintiff who owns a negligible amount of stock in SPS, is openly antagonistic toward the other shareholders in the corporation, and has strong personal reasons for prosecuting the lawsuit against the named defendant – cannot fairly and adequately represent the interests of other shareholders as required by Rule 23.1.*

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* Regardless of Andrew's status as a shareholder in SPS, he may not sue as the assignee of the other shareholders' derivative claims [sic]. A 10b-5 plaintiff must prove not only that he is a purchaser or seller of securities, Blue Chip Stamps v. Manor Drug Store, 421 U.S. 723 (1975), but also that the purchase or sale was "in connection with" the fraud of which the plaintiff complains. *See* Superintendent of Insurance of the State of New York v. Bankers Life and Casualty Company, 404 U.S. 6, 10, 12 (1971). A 10b-5 plaintiff must demonstrate "both *loss causation* – that the misrepresentations or omissions caused the economic harm – and *transaction causation* – that the violations in question caused the [plaintiff] to engage in the transaction in question. Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374, 380 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975). *See also* Huddleston v.

In Cohen v. Beneficial Industrial Loan Corporation, 337 U.S. 541, 549 (1949), the Supreme Court noted the fiduciary nature of the relationship between the plaintiff in a shareholder derivative action and the other shareholders that plaintiff represents:

> Likewise, a stockholder who brings suit on a cause of action derived from the corporation assumes a position, not technically as a trustee perhaps, but one of a fiduciary character. He sues, not for himself alone, but as representative of a class comprising all who are similarly situated. The interests of all in the redress of the wrongs are taken into his hands, dependent upon his diligence, wisdom and integrity.

The court is not convinced that Andrew can rise to the status of a fiduciary with respect to the interests of his brothers Mark and Clayton, given his clearly expressed antagonisms toward them and the named defendant, and his negligible stake as a shareholder in tbe corporation.

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Herman & MacLean, 640 F.2d 534, 549 n.24 (5th Cir. 1981), *aff'd in part, rev'd in part,* 459 U.S. 375 (1983). This requirement extends to assignees of 10b-5 claims. In re Saxon Securities Litigation, 644 F.Supp. 465, 470 (S.D.N.Y. 1085). "If a 10b-5 claim could be assigned, whether implicitly or otherwise, the purchaser/seller requirement might be effectively abridged. Remote purchasers who were never touched by any fraud would have standing to assert the claims of the defrauded purchser/seller." *Id.*

Andrew is such a remote purchaser. The Fifth Circuit has already determined that he was not touched by any fraud because he voted against issuing shares to Clayton. *See Ayres,* 845 F.2d at 1364. Accordingly, Andrew is not the proper assignee of the other shareholder's 10b-5 claims [sic].

## III. Conclusion

Because Andrew has not met the requirement of fair and adequate representation set out in Rule 23.1 of the Federal Rules of Civil Procedure, the court is unwilling to allow him to continue prosecution of this shareholder derivative action. Accordingly, Ayres' supplemental motion to dismiss is hereby GRANTED.

SO ORDERED.

April 12, 1991.

/s/ A. Joe Fish
A. JOE FISH
United States District Judge

## APPENDIX C

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF TEXAS
DALLAS DIVISION

| | | |
|---|---|---|
| ANDREW L. SMITH, | § | CIVIL ACTION NO. |
| Plaintiff, | § | CA3-85-2628-G |
| | § | |
| vs. | § | |
| R. JACK AYRES, JR., et al., | § | |
| Defendants. | § | |

JUDGMENT

(Filed July 10, 1991)

For the reasons stated in the Court's April 12, 1991 Memorandum Order granting the Supplemental Motion to Dismiss of Defendants R. Jack Ayres, Jr. and R. Jack Ayres, Jr., P.C.,

It is hereby ORDERED, ADJUDGED and DECREED that Plaintiff take nothing by this action, and that Defendants recover their costs of court.

It is further ORDERED that the Clerk shall transmit a true copy of this judgment to counsel of record.

~~June~~ July 9, 1991.

/s/ A. Joe Fish
A. JOE FISH
United States District Judge